BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WESTERN BUTANE SERVICE, INC.)

For Appellant: John F. Fennel1
Certified Public Accountant

For Respondent: Crawford H. Thomas
Chief Counsel

Peter S. Pierson
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Western Butane Service, Inc. for refund of franchise tax in the amounts of $842.00 and $736.74 for the taxable years ended September 30, 1963, and September 30, 1964, respectively,

Appellant was incorporated on October 29, 1962, as a wholly-owned subsidiary corporation of Pacific Delta Gas, Inc., hereafter referred to as "Pacific." On November 1 of the same year Pacific exchanged approximately 6/10 of 1 percent of its outstanding shares of common stock for all the assets of a corporation, hereafter referred to as "Western." On the same date Pacific transferred all the assets received from Western to appellant, Western's business, employees, and location have been continued by appellant without substantial change.

Western distributed the Pacific stock to its shareholders and dissolved, A final return for the period July 1, 1962, to December 28, 1962, reported net income of $135.82 and showed that only the minimum $100 tax was due,

Appellant's first return covered the period of October 29, 1962, to September 30, 1963, and showed net income of $16,582. Over the full year ended September 30, 1964, appellant received net Income of $29,775. Respondent

Franchise Tax Board has concluded that appellant should be taxed as a commencing corporation under section 23222 of the Revenue and Taxation Coda. Appellant has paid the taxes accordingly, but has filed claims for refund on the ground that it was commencing business in this state pursuant to a reorganization and therefore section 23222 does not apply. The sole issue presented is whether appellant commenced to do business pursuant to a reorganization.

Section 23251 of the Revenue and Taxation Code defines reorganization and includes in subsection (c)"a merger or consolidation.." If a reorganization has occurred section 23252 of the same code states that the commencing corporation provisions do not apply.

Appellant contends that the transaction is a merger within section 23251(c). The primary requisite of a merger is that the former owners of the merged corporation must have retained a continuing proprietory interest in the transferee corporation which was definite and substantial and represented a material part of the value of the thing transferred. (Heating Equipment Mfg. Co, v. Franchise Tax Board, 228 Cal, App. 2d 290 [39 Cal. Rptr. 453].) In the instant case Western's former shareholders retained a continuing proprietory interest in the transferee corporation, appellant, but this interest was indirect, That is, the interest was continued by virtue of their acquisition and ownership of Pacific stock. Respondent contends that an indirect interest does not qualify as a definite, substantial, and material, continuing interest, and therefore no merger existed.

The predecessors of the present reorganization sections were enacted in 1933 to remedy a considerable inequity in the Bank and Corporation Franchise Tax Law. As stated by Roger J. Traynor and Frank M. Keesling in "Recent Changes in the Bank and Corporation Franchise Tax Act," 23 Cal. L. Rev. 51, 62:

> Until the 1933 amendments, the Act made no provision for reorganizations, consolidations, and mergers. Banks or corporations dissolving or withdrawing from the state in any year, even when pursuant to a reorganization, consolidation or merger, obtained an abatement or refund of the tax for that year measured by the net income for the preceding year, As a result a portion of the income for the preceding year escaped taxation; likewise the net income for the months of the year in which dissolution or withdrawal

> occurred did not become the measure of any tax imposed by the Act. A bank or corporation which came into existence through reorganization or consolidation was considered as a commencing bank or corporation, and its tax liability for its first and second taxable-years was computed on that basis. Thus, a change in the corporate structure of a business sufficed to change considerably the amount of taxes due.

Sections 23253 and 23332 of the Revenue and Taxation Code presently remedy this inequity by taxing the transferee corporation in the taxable year succeeding the reorganization on the net gain received by the transferor corporation during the taxable year in which the transfer occurs and by denying the transferor any abatement or refund of franchise tax for its last taxable year because of cessation of business or corporate existence. However, this remedy only operates when a transaction can be first classified as a reorganization. With this in mind the court in San Joaquin Ginning Co. v. McColgan, 20 Cal. 2d 254, 259, 260, stated:

> The rule to be applied in the interpretation of the terms reorganization, merger and consolidation in relation to exemptions, abatements and refunds in the taxing provisions is the rule of liberal construction. And the language is language of exemption even though a portion thereof partakes of the form of a taxing provision..,. Also, in conformity with the legislative purpose, consolidation or merger as a form of reorganization is not restricted to statutory consolidation or merger in the absence of appropriate language of limitation.

In the instant situation, if Pacific had employed the operating assets received from Western as merely a division of Pacific, a merger definitely would have occurred. (Appeals of Duro Fittings Company and Duro Sales Co., Cal St. Bd. of Equal., Feb. 5, 1963.) However, Pacific went one step further and transferred these assets to appellant, a wholly-owned subsidiary. Appellant operated them without substantial change in the type of business, employees or location. Western's former shareholders, by receiving 6/10 of 1 percent of Pacific stock retained just as valuable a proprietory interest and just, as strong

control over the transferred assets as if Pacific had operated the assets as a division of itself. We think that the former shareholder's continuing interest in appellant, even though indirect, was sufficiently definite, substantial, and material to satisfy the prerequisite of a merger under section 23251(c).

Respondent's regulations add support to the above conclusion. Regulation 23251-23254(c), title 18, California Administrative Code, effective July 22, 1953, explains section 23253(c) of the Revenue and Taxation Code, which defines "party to the reorganization." This regulation states as an example a fact situation which is identical to the instant case except that the corporation comparable to Pacific is located outside California and has no activities here. The regulation concludes that the example's counterpart of appellant is a party to the reorganization rather than a commencing corporation. We must reject respondent's contention that this regulation only has application once a reorganization is found. The regulation can only have meaning if a reorganization is found on the facts stated in the example.

Respondent contends that the Appeal of Meyenberg-Old Fashion Products Company, Cal, St. Bd. of Equal., Oct. 1, 1963, is controlling in the instant situation. In Meyenberg, this board held that a merger had not occurred and stated:

> In order to establish that a merger occurred within the meaning which concerns us here it must be shown that Meyenberg, the former owner of a portion of the assets and the former stockholder of Old Fashion which owned the balance of the assets, retained a definite and material continuing interest in the transferred assets, (Cases cited.) The indirect interest retained by Meyenberg, as the owner of part of the stock of Starrett, which in turn owned the stock of Appellant, the ultimate owner of the assets, does not qualify (Groman v. Commissioner, 302 U. S. 82 [82 L. Ed. 63]; Bashford v. Commissioner, 302 U. S. 454 [82 L. Ed. 367] . .*.

We do not believe that the distinction drawn in Meyenberg between direct and indirect interests is valid. The Groman and Bashford cases, cited as authority for the Meyenberg decision, have been criticized because of their potential limitation upon the use of subsidiary corporations

in reorganizations. (See Traynor, "Tax Decisions of the Supreme Court, 1937 Term," 33 Ill. L. Rev. 371, 389.) Both Groman and Bashford dealt with the recognition of pain or loss under a predecessor of the present section 368 of the Internal Revenue Code. With respect to transactions after December 31, 1963, section 368 was amended to reverse, in effect, the holdings in these cases.

Regulation 23251-23254(c), supra, was not discussed in the Mevenberg decision. The subject regulation, effective in 1953, represents a longstanding administrative interpretation by the Franchise Tax Board and it is in direct conflict with the Meyenberg decision and with the Groman and Bashford cases,

The Meyenberg decision has had the unforeseen effect of allowing a taxpayer to chose whether or not a transaction will be classified as a reorganization. That is, through the creation of a wholly-owned subsidiary corporation to receive the transferred assets, the taxpayer could avoid reorganization status. In certain situations under section 23251 this option can have considerable tax effect. Such an option is neither warranted under the statute nor desirable.

We conclude that under a liberal construction of the organization statute a continuing, indirect proprietory interest, like that presented in the instant case, is sufficiently definite, substantial and material. Therefore, we hold that the subject transaction was a merger under section 23251(c) of the Revenue and Taxtion Code. Any language to the contrary in Appeal of Meyenberg-Old Fashion Products Company, supra, Cal. St, Bd. of Equal., Oct. 1, 1963, will not be followed,

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Anneal of Western Butane Service, Inc.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Western Butane Service, Inc. for refund of franchise tax in the amounts of $842.00 and $736.74 for the taxable years ended September 30, 1963, and September 30, 1964, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 5th day of August, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary